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STATE TAXATION OF EMPLOYEE RETIREMENT AND DEATH BENEFITS

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INTRODUCTION

ACCENTUATED by the depression of the 1930's which dramatized the economic insecurity of society, we have witnessed in the past twenty-five years a tremendous growth in the search for economic security for the individual. The opportunity for a person to protect himself and his family against economic hazards is essential to the welfare, freedom and dignity of the American citizen. Specifically, these economic hazards take the form of three contingencies: (1) The loss of livelihood because of the death or disability of the family's principal provider; (2) The hazards of illness, accident or loss of employment; and (3) The lack of adequate income for the overaged employee and his dependents.

Economic security for the individual may be viewed as an attempt to insure a continuity of income, which can be translated into purchasing power for the benefit of the individual and his dependents. Such financial stability may be created in several different ways and at any of the levels of our government. Its most prevalent form today is social insurance in the form of social security and workmen's compensation laws. However, another type of payment created by government exists in the case of definite services rendered to it by an individual, e.g., military retirement, civil service retirement and pensions.

Continuity of income may also be created by the individual, himself, or by his employer. The former may make it available through prior savings, or investments in life insurance, annuities, stocks, bonds, or real estate. The latter has usually resorted to private insurance or retirement trust plans. Favorable federal income tax treatment accorded to certain types of pension and profit sharing plans, which meet the specifications of the Internal Revenue Code, has provided these retirement programs a healthy atmosphere in which to grow.¹

The constant development and expansion of such retirement plans has necessarily engendered a new interest in the state taxation of their benefits.² The continuity of income received by the overaged worker,

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2. At the end of the first quarter of 1960, there were an estimated 58,000 pensions and profit sharing plans in effect. Of these, 60% were pension plans, and the remainder were profit sharing plans. In addition, there were an estimated 5,000 cash and deferred profit
the injured worker, the retired individual or the beneficiaries of a deceased may, or may not, give rise to a taxable event for state tax purposes. Determination of the state tax liability, if any, requires careful consideration and analysis. The purpose of this article is to determine the status of retirement and death benefits and their liability under state tax statutes. Accordingly, it is necessary to consider the various types of payments in relation to income, inheritance or gift taxation.

PART ONE: STATE INHERITANCE TAXATION OF DEATH BENEFITS

Pension, profit sharing and retirement plans sponsored by commercial or industrial enterprises take a wide variety of forms. Some of the factors which influence the form of plan include the size of the particular company, in both resources and number of employees, its experience with employee turnover, the approach it desires to use in its plan, the scope of the plan, the nature of the benefits, the question of funded versus unfunded and trusteed versus nontrusteed plans, and a variety of other considerations. The principal objective of the plan, however, is to benefit the employee at his retirement or his dependents at his death.

Death benefits payable under pension and profit sharing plans, and

sharing plans in existence. McMahon, Gains Recorded in Profit Sharing, N.Y. Times, June 26, 1960, § 3 (Financial), p. 27, col. 2. At the end of the calendar year 1958, there were an estimated nineteen million employees covered by private pension and deferred profit sharing plans. This represented an increase of about ten million over the number of employees covered in 1950. More than three-fourths of the employees were covered by private plans. These were noninsured plans, such as “trusteed” funds, multi-employer plans, union plans with no employer participation, “pay-as-you-go” plans, plans of nonprofit organizations, and deferred profit sharing plans. The remaining one-fourth of the employees were covered under insured plans underwritten by private insurance companies. Since 1950, employee coverage under noninsured programs has more than doubled, and coverage under insured plans has increased by about three-fourths. The amount contributed in 1958 to finance private retirement plans was almost $4.7 billion of which it is estimated that employers contributed about 85%. This rate of contribution has remained about the same during the period 1950-1958. There were estimated to be 1,410,000 beneficiaries receiving periodic payments, totaling $1.3 billion from private pension funds at the end of 1958. The benefits paid under noninsured plans included: (1) refunds of employee contributions made to individuals who withdrew from the plan before retirement or before accumulating vested rights; (2) payments to survivors of pensioners who died before they received retirement benefits equal to the amount of their contributions; and (3) lump sum payments made under deferred profit sharing plans. Skolnick, Employee-Benefit Plans, 1954-58, Social Security Bull. vol. 23, No. 3, p. 3 (1960). For an earlier report see Skolnick & Zisman, Growth in Employee-Benefit Plans, 1954-57, Social Security Bull. vol. 22, No. 3, p. 4 (1959). During 1958, trusteed corporate pension fund totals reached a high of $22.1 billion in book value, thus exceeding for the first time the reserves of $21.9 billion at book value of the Government’s Old Age and Survivors Insurance Fund. 98 Trusts & Estates 561 (1959).
other employee retirement benefits may, or may not, be includible in the deceased employee’s gross estate for state inheritance tax purposes. The application of state inheritance taxation to death benefits payable under such plans arises under the general statutory provisions designed to tax a transfer of property intended to take effect in possession or enjoyment at or after death.  

Prior to 1948, it was difficult to find a state tax decision involving inheritance taxation of death or employee retirement benefits. During the 1950’s, however, there were ten such cases decided by the highest courts in nine states. 4 Already in this decade there have been three such decisions from the highest courts in as many states. 5 There has also been a large number of opinions from local courts of record, such as surrogate’s and orphans’ courts, from which appeals were either not taken or denied.

The cases have generally dealt with death benefits payable under combined profit sharing and pension plans which either were trusteeed, with payment being made directly by the trustee, or else involved insurance companies and the annuity contract approach. There are varying degrees of the vested interest of the employee, including the right to...

3. A fairly typical example of the state inheritance tax statutes is Va. Code Ann. § 58-152 (1959), which provides in part as follows: “State inheritance taxes as hereinafter prescribed are hereby levied upon the shares of the respective beneficiaries in all property within the jurisdiction of this Commonwealth, real, personal and mixed, and any interest therein, which shall pass . . . (2) By grant or gift made or intended to take effect in possession or enjoyment at or after the death of the grantor or donor . . . [or] (4) By a transfer under which the transferrer has retained for his life the possession or enjoyment of the property or the income therefrom or the right to designate or change the beneficiaries who shall be entitled to possess or enjoy the property or the income therefrom . . . .”


5. Gould v. Johnson, 156 Me. 446, 165 A.2d 481 (1960); In the Matter of Estate of Clark, 10 Utah 2d 427, 354 P.2d 112 (1960); In re Estate of Stone, 10 Wis. 2d 467, 103 N.W.2d 663 (1960).
designate a beneficiary. Most of the plans are noncontributory from the employee's standpoint; that is, the employer is the sole contributor to the plan. In about half of the cases, death has occurred after retirement; in the remainder, death of the employee occurred prior to retirement.

I. COMBINED PENSION AND PROFIT SHARING PLAN WITH CONTRIBUTIONS BY EMPLOYER AND EMPLOYEE

One of the first reported state tax decisions under this heading, In re Dorsey's Estate,6 arose in Pennsylvania in 1951. The fund involved was composed of a portion of employees' wages, together with contributions by the employer from profits. The death benefit could be paid to the employee's designated beneficiary in the form of cash or could be used to purchase annuities. The trustees had discretionary power to determine the mode of payment and there was no reversion to the company. At the time of his death, the total credits to the decedent's account in the plan were valued at approximately $39,000, of which only about twelve per cent was the decedent's contribution.

The Pennsylvania statute provided that the transfer inheritance tax be imposed upon the transfer of any property made by a resident by deed, grant or gift intended to take effect in possession or enjoyment at or after the death of the grantor or donor.7 The question before the Dorsey court was whether the decedent's share in the combined pension and profit sharing plan was subject to taxation under this statute. The court held that the interest of the deceased participant was vested, and hence, subject to the state transfer inheritance tax. The court asserted:

[H]e had . . . substantial ownership of his entire share of the fund and accordingly, in transferring it to the beneficiary designated by him he was transferring not only his own property to the extent that it represented contributions from his salary,

6. 366 Pa. 557, 79 A.2d 259 (1951). It has since been cited as a leading case in this field.
7. "A tax shall be, and is hereby, imposed upon the transfer of any property . . . in the following cases . . . (c) When the transfer is of property made by a resident . . . by deed, grant, bargain, sale or gift made in contemplation of the death of the grantor, vendor, or donor, or intended to take effect in possession or enjoyment at or after such death." Pa. Stat. Ann. tit. 72, § 2301 (1949). This section has been repealed insofar as it relates to estates of decedents dying on or after January 1, 1962. Pa. Stat. Ann. tit. 72, § 2301 (Supp. 1961). Pa. Stat. Ann. tit. 72, § 2485-316 (Supp. 1961), effective January 1, 1962, specifically exempts from taxation those payments made under pension, stock-bonus or profit sharing plans to distributees designated by the decedent or in accordance with the terms of the plan other than the estate of the decedent, to the extent that the decedent prior to death did not otherwise have the right to possess, enjoy, assign or anticipate the payments so made. Similarly, Pa. Stat. Ann. tit. 72, §§ 2485-314, 2485-315 (Supp. 1961) exempt lump sum Social Security death payments and lump sum Railroad Retirement burial payments.
but also his own property to the extent that it represented his proportionate share of the Company's contributions. . . .

As to the discretionary power held by the trustees to determine mode of payment at the time of employee's withdrawal or in the event of his death, the court held that this in no way limited the absolute right of the employee to withdraw his share of the property in the fund or to dispose of it at his death. The discretionary powers of the trustee governed only the form in which the employee or his estate would receive the proceeds and had no contrary effect on the broad vesting features inherent in the plan.

Thus, because of the extensive vesting aspect of the program, a valuable property right existed in the employee, and this was transferred to the designated beneficiary upon the death of the employee. Such a transfer was subject to the Pennsylvania transfer inheritance tax as a grant or gift intended to take effect in possession or enjoyment at or after the death of the grantor or donor.

II. COMBINED PENSION AND PROFIT SHARING PLAN WITH CONTRIBUTIONS SOLELY BY EMPLOYER

The leading case on this subject appears to be In re Estate of Daniel. There, the plan was trusteed, and the retirement benefit was provided by funds entirely contributed by the company. The company relinquished all right of ownership in the fund which was payable, according to the terms of the trust, to the participating employee on reaching retirement age, or, on death, to a designated beneficiary changeable at will by the employee. In the absence of a designation, the benefits were payable to the estate of the employee.

The Ohio statute provided that property would be subject to inheritance taxation:

When the succession is to property from a resident . . . by deed, grant, sale, assignment, or gift, made without a valuable consideration . . . [and] intended to take effect in possession or enjoyment at or after . . . death. . . .

The court held that the payment of the accumulated interest of the participating employee to his designated beneficiary was a taxable succession under Ohio inheritance tax law since it was a transfer "intended to take effect in possession or enjoyment at or after . . . death." The court

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8. 366 Pa. at 562, 79 A.2d at 261.
9. See note 7 supra.
10. 159 Ohio St. 109, 111 N.E.2d 252 (1953).
rejected the taxpayer's contention that the decedent had no ownership in the fund at or prior to his death, so that the designation of a beneficiary by him did not amount to a "succession" within the meaning of the Ohio statute. Under the facts of the case the decedent possessed a sufficient property right in the trust fund to bring it within the purview of a taxable succession.

The trust fund belongs to the employees, each being the owner of his allotted portion, although the actual possession and control thereof is postponed pending severance or retirement of the employee. . . . In the meantime, each employee has a vested property right in the trust fund. . . . The protection and preservation of such fund from assignment, attachment or execution "prior to such actual payment or delivery" does not have the effect of taking it out of the category of a "succession" as defined by the provisions of the statute. 

No weight was given to the dissenting opinion in the intermediate appellate court, which would have ruled that there was no tax liability since nothing passed from the decedent to the person named. According to that theory, the property passed from the trustee to the designated beneficiary upon the death of the employee. 

That dissent also sharply distinguished the facts of the instant case from those in Dorsey and invoked the doctrine of strict construction of the taxing statute; that is, that it should be strictly construed against the taxing authority and liberally construed with respect to the taxpayer in cases of ambiguity or doubt.

In re Brackett's Estate involved substantially the same question as Daniel. There, the employer deposited annually a percentage of its profits with a trustee who clerically allocated each deposit among the company's employees in proportion to the amount of their salaries. The employee's interest in past contributions could not be impaired or recaptured by the company, and an employee was entitled to his proportionate share if his employment terminated for any reason. The employee also had the sole right to designate a beneficiary.

The issue before the court was whether or not the deceased employee's share of the profit sharing fund, passing to the beneficiary designated by the employee, was taxable as a transfer intended to take effect in possession or enjoyment on or after the employee's death. In holding that the death benefit was taxable under the Michigan inheritance tax statute, 

13. 159 Ohio St. at 113-14, 111 N.E.2d at 254-55.
14. 93 Ohio App. 123, 130, 112 N.E.2d 56, 60 (1952) (dissenting opinion).
16. "[A] tax shall be and is hereby imposed upon the transfer of any property . . . in the following cases . . . Third, When the transfer is of property made by a resident . . . by deed, grant, bargain, sale or gift made in contemplation of the death of the grantor, vendor or donor or intended to take effect, in possession or enjoyment at or after such death." Mich. Comp. Laws § 205.201 (1948).
the court admitted that the case was one of first impression in Michigan. While it acknowledged that there were certain restrictions upon the participant's dominion over the proceeds of the fund while held by the trustee, it discussed at great length the property interest of the decedent in the plan. Despite the fact that the participant could not reduce the funds to his physical possession while he was still employed by the company, the money belonged to the participant and could not be recaptured by the company for its own use or benefit. Thus, the court construed the plan to be in the nature of additional compensation earned by the participant but deferred in enjoyment. It stated: "[T]he essence of a transfer has come to be identified more nearly with a change of economic benefits than with technicalities of title."

Finally, the court replied to the strict construction argument by declaring that taxation is a practical matter and taxing statutes must be practically construed. Such provisions should not be interpreted so narrowly as to defeat the manifest purpose or intent of the legislative action.

The results reached in Daniel and Brackett are identical as to taxable effects. Both courts indicated that the decedent possessed a vested interest sufficient to support the taxation of the property. In Daniel, the theory that the decedent possessed a sufficient property right in the trust fund was emphasized, while in Brackett, the transfer of property rights in the form of a substantial economic benefit derived from the contract of employment was the major factor.

III. TRUSTEED PENSION AND RETIREMENT ANNUITY CONTRACTS PURCHASED BY EMPLOYER

Cruthers v. Neel" concern a trusteed plan where the company purchased and paid the premiums on retirement group annuities pursuant to an employees' trust. The trustee was designated as the sole owner of

17. 342 Mich. at 206, 69 N.W.2d at 169.
18. See note 14 supra and accompanying text.
19. 342 Mich. at 205, 69 N.W.2d at 169.
20. On facts similar to Daniel and involving essentially the same type of plan, the Supreme Judicial Court of Maine held in Gould v. Johnson, 156 Me. 446, 166 A.2d 431 (1960) that designation of his wife by the decedent to receive his death benefits constituted a grant of an interest in property within the statutory meaning of a transfer of an interest in property made or intended to take effect in possession or enjoyment on or after death of the grantor or donor. The court declined to accept the widow's contention that the decedent had at most a "mere expectancy" coupled with a special and limited power of appointment, neither of which would be subject to the Maine inheritance tax. This case was one of first impression for the Maine court.
the contract with the right to designate the beneficiary thereof. Provision was made for monthly payments to the decedent during his lifetime after retirement, with a guarantee of 120 monthly payments. In the event of the participant’s death prior to retirement the contract provided for payment to the beneficiary of an amount equal to the cash surrender value thereof, or to the total premiums paid, whichever was the greater. Although the premiums on the various contracts were paid by the employer through the medium of the trustee, there was withheld from employee’s salaries an amount which represented his contribution towards the cost of the benefits.

About nine months prior to his scheduled retirement from the company, the decedent died, still in the employ of the company. Apparently he could, and did, designate his widow to receive the payments in event of his death. As a result of the death before retirement, the insurance companies were obligated to repay to the named beneficiary the total premiums paid on the contracts. These proceeds were included by the State of New Jersey in the decedent’s gross estate, and pursuant to statute\(^\text{22}\) were taxed as a transfer intended to take effect in possession or enjoyment at or after death.

In arguing that the death benefit was excludable from inheritance taxation, the estate contended that the benefit was comparable to life insurance proceeds and should be omitted under the general exclusion provision for life insurance proceeds. It was also vehemently maintained that inasmuch as the trustee was the designated owner of the policy, nothing passed to the beneficiary from the decedent, either at or after his death. The court rejected the life insurance exemption argument on the grounds that the policies lacked the necessary risk elements and were quite contrary to the risks ordinarily associated with life insurance. As to the trustee’s ownership, the court stated in part:

Fanciful rationalism must give way to a realistic and analytical interpretation of the documents under scrutiny, and such treatment discloses the policies in question to be retirement annuity contracts. In this status it becomes unimportant what interest, equitable or otherwise, the decedent had in the proceeds, for the tax is on the succession rather than on any divesting of the transferor’s ownership.\(^\text{23}\)

Thus, the court held the succession tax falls upon a beneficiary’s succession to property rather than upon the decedent’s “interest” in

\(^{22}\) “[A] tax shall be and is hereby imposed . . . upon the transfer of property . . . in the following cases . . . c. Where real or tangible personal property within this State of a resident of this State . . . is transferred by deed, grant, bargain, sale or gift made in contemplation of the death of the grantor, vendor or donor, or intended to take effect in possession or enjoyment at or after such death.” N.J. Stat. Ann. § 54:34-1 (1960).

\(^{23}\) 14 N.J. at 502-03, 103 A.2d at 156.
property. The inheritance tax assessment upon the widow's receipt of the contract proceeds was affirmed even though the company had paid the premiums and the trustee was sole owner of the contracts. It appears that the case can be reconciled with those holding that the decedent possessed a sufficient property right to constitute a valuable economic interest passing as a transfer intended to take effect at or after his death.

A recent case similar to Cruthers is In the Matter of Estate of Clark. There, too, the employee was covered by a retirement plan group annuity contract. In Clark, however, the premiums were equally divided between the employer and the employee. The employee was entitled to receive a lifetime annuity upon retirement and had the right to designate and change the beneficiary under the death benefit clause. If the employee died before retirement while annuities purchased with his contributions were in force, the insurance company would pay a single sum death benefit to the named beneficiary in an amount equal to the accumulation of the employee's purchase payments.

The decedent died while still an employee, having named his wife as beneficiary under the death benefit clause of the contract. She failed to include the amount received under the contract in the inheritance tax report upon the decedent's estate, contending that the proceeds were in the nature of life insurance benefits payable to a named beneficiary, hence, not subject to inheritance taxation. The court rejected this contention and proceeded to distinguish between annuity contracts and contracts of life insurance. In holding the proceeds received under the death benefit clause to be subject to inheritance taxation as property passing by a gift intended to take effect in possession or enjoyment at or after death, the court cited many cases with similar holdings but failed to mention Cruthers, which appears to be more closely in point factually than any of the authorities cited.

Thus, the decision in Clark, like that of Cruthers, seems to be reconcilable with those cases holding that the decedent was possessed of a sufficient property right or valuable economic interest which passed at death and was therefore subject to state transfer inheritance tax.

IV. SURVIVORSHIP ANNUITIES

One of the earliest cases involving the inheritance taxation of a survivorship annuity was Borchard v. Connelly. There, an annuity was

25. Id. at 430-31, 354 P.2d at 114. It should be noted, however, that this was the opinion of a divided court, the two dissenting judges agreeing with plaintiff's exclusionary theory.
issued to the decedent in 1920 by the Teachers Insurance and Annuity Association of America. All of the premiums were paid by Yale University under a special arrangement with the decedent, and were in addition to his salary. Subsequently, the decedent chose to exercise an option which provided for monthly payments beginning July 1, 1950 and in the event of his death, if the sum of payments should be less than the guaranteed minimum return under the contract, the annuity payments would continue to be paid to the surviving annuitant until that amount was reached. Upon decedent's death the computed value of the unpaid installments was about $16,000 and this was included in the decedent's estate as a "gift or grant intended to take effect in possession or enjoyment at or after the death of the transferor," and also as a transfer under which the decedent retained for his life . . . (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person or persons, to designate the person or persons who shall possess or enjoy the property or the income therefrom. . . .

In affirming the taxability of the survivor's annuity, the court stated that it was the apparent intent of the legislature in enacting Section 12-341 of the Connecticut General Statutes, to reach, for purposes of succession taxation, the "economic benefits" or the "economic interests." The fact that Yale University paid the premiums on the contract did not, in the court's opinion, alter the fact that the annuity contract was the property of the decedent, since the contractual obligation of the insurance company ran directly to the decedent. It was the decedent's annuity, and it was the decedent who made the transfer of an interest in property to his wife when he exercised an option in her favor.

Prior to statutory change in 1959, New York held that the value of survivorship annuities were subject to estate tax. The controlling case was *In the Matter of Estate of Endemann.* There, the decedent, an employee of New York City and a member of the city's employee retirement system, selected an option upon retirement, which provided for a reduced annuity for himself and his widow after his death. A unanimous court held that the selection of this option constituted a transfer of property by the decedent to his wife which was intended to take effect

27. Conn. Gen. Stat. Rev. § 12-341(d) (Supp. 1961). Conn. Gen. Stat. Rev. § 12-349 (Supp. 1961) now excludes from the decedent's gross estate the value of employee death benefit payments, to beneficiaries other than the decedent's estate, from plans exempt from federal income taxation except such proportion as represents the decedent's contribution. For purposes of determining such contributions, those made by the decedent's employer are not to be considered as having been donated by the decedent.
at death. The court rejected the argument of the surviving annuitant to the effect that the transfer was completed when the decedent chose the option and that, therefore, nothing took effect upon his death. Likewise, the contention that what the decedent did at his retirement was "merely to renounce part of his retirement rights in favor of his wife, like a legatee renouncing a legacy" did not meet with judicial approval. The court stated:

Here, Endemann had built up for himself, by contributions of money and services, a fund which, at retirement, he had a contractual right to dispose of in any one of several ways—he chose a way which involved a transfer to his wife, effective at his death.

Thus, Endemann held that the total amount of the survivorship annuity was subject to inheritance taxation, even though the employer had been the primary contributor. A year after this decision, the New York State Legislature amended the Tax Law, effective in 1959, so as to modify the Endemann rule. The amendment provided that under any plan which meets the general qualification provisions of the Internal Revenue Code payments to the beneficiary of the annuity are excluded from the decedent's gross estate, for purposes of inheritance taxation, in the same proportion that contributions to the plan were made by the decedent. For purposes of determining such contributions under this amendment those made by the decedent's employer are to be considered as having been contributed by the decedent, if made by reason of his employment.

30. The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property "(a) To the extent of any interest therein of which the decedent has at any time made a transfer ... (iii) intended to take effect in possession or enjoyment at or after his death." N.Y. Sess. Laws 1954, ch. 1C0, § 1.
31. 307 N.Y. at 107-08, 120 N.E.2d at 513.
32. Id. at 108, 120 N.E.2d at 513. Because the decedent was a member of the New York City Employees' Retirement System, a constitutional question was involved as to whether the New York Constitution forbade the taxing of this type of annuity. N.Y. Const. art. XVI, § 5 provides: "All salaries, wages and other compensation, except pensions, paid to officers and employees of the state and its subdivisions and agencies shall be subject to taxation." The surrogate's court held that while the transfer was one intended to take effect at death, the transfer could not be taxed because the state constitution prohibited the taxing of "pensions." 201 Misc. 1077, 106 N.Y.S.2d 849 (Surr. Ct. 1951). The appellate division held that the constitutional exclusion was not applicable to retirement pay. 282 App. Div. 765, 122 N.Y.S.2d 652 (2d Dep't 1953) (memorandum decision). The court of appeals affirmed, stating that the word "pensions" was added to the above section of the constitution out of an abundance of caution to make sure that the section could not be construed to make pensions subject to income tax, since they were already exempt from income tax under another section of the statute. 307 N.Y. at 106, 120 N.E.2d at 517.
33. N.Y. Tax Laws § 249-r.
Survivorship annuities which may be elected by members of the armed services under the military retirement plan apparently are to receive no preferred treatment over privately purchased annuities or insured commercial plans. An opinion of the Corporation Counsel of the District of Columbia, dated September 23, 1955, holding that survivorship annuities payable under the Uniformed Services Contingency Option Act of 1953 were subject to inheritance taxation in the District of Columbia, reads in part as follows:

The 1953 Act created a new right in retired members of the uniformed services by allowing an election to receive reduced retirement pay, and thereby provide annuities for their widows. Both decedents here involved, by irrevocable election, reduced the retirement which they were receiving at the time of their election and thereby provided annuities for their widows, which were to take effect in possession and enjoyment upon the retired member's death.

In general, then, state inheritance taxation of a survivorship annuity as a transfer intended to take effect in possession or enjoyment at or after death seems fairly well established. The right to designate a beneficiary and the substantial shifting of economic interests from the decedent to the beneficiary appear clearly sufficient for the imposition of the tax.

V. Noncontributory, Unfunded, and Nontrusteed Insurance Retirement Plan—Decedent Not Retired

Dolak v. Tax Comm'r is a Connecticut decision holding retirement plan benefits to be subject to inheritance taxation. There, the retirement plan was noncontributory, unfunded, and nontrusteed. It gave the employee no rights and did not cover him if he left the company for any reason other than death or retirement. The company reserved the right to discontinue or modify the plan at any time, with the exception that benefits being paid to retired employees would not be reduced. The decedent, at the time of his death, was actively employed by the company and under the plan's death benefit option had elected to make his wife beneficiary of an annuity, rather than of the normal lump sum payment. At no time, either before or after election, had the decedent become entitled personally to receive any retirement allowance or other money benefit under the plan.

Pursuant to the decedent's election to take a death benefit option, the company made monthly payments to the spouse. The court noted that the lower court had held such annuity payments not subject to inheritance

38. 145 Conn. 497, 144 A.2d 312 (1958).
taxation on the ground of lack of an enforceable contract during the
decedent's lifetime; the decedent's wife did not succeed to anything
that the decedent owned, since the decedent had only a mere expectancy
and had owned nothing. On appeal, this finding was unanimously re-
versed. Apparently for the first time, the Connecticut court held the
surviving spouse to be a third party contingent beneficiary whose rights
became fixed upon the decedent's death. The tax was imposed upon the
theory that the decedent parted with valuable consideration in favor of
his company in exchange for contractual obligations running not only to
himself, but also directly to his spouse as a contingent third party ben-
ficiary. Such benefits as finally accrued to the contingent third party
beneficiary took effect in possession and enjoyment at the death of the
decedent within the meaning of the Connecticut statute.

A nontax case decided on the ground that the surviving wife was a
third party beneficiary of a valid contract, with a vested though defeasible
interest, is Buehler v. Buehler. There, the defendant was the second
wife and surviving widow of an intestate decedent. The decedent was a
participant in an employees' profit sharing retirement plan which pro-
vided that certain benefits would accrue to the deceased upon his retire-
ment, resignation, dismissal, disability, or death. The defendant was
designated by the decedent as beneficiary of these benefits. A suit was
instituted by the plaintiff as the decedent's only child, alleging that the
designation of the beneficiary under the plan was testamentary in char-
acter and not executed with the formality required under the statute of
wills. The trial court awarded the plaintiff his intestate share of the
contested benefits.

The appellate court reversed, and took the view that the designation
of the beneficiary was not testamentary in character. It held that the
defendant was a third party beneficiary of a valid contract and compared
this type of contract to the purchase of Series E United States Savings
Bonds in which benefits were paid to the owner or his spouse. Such a
contract gives the spouse a vested, though defeasible, contractual right
which has been held not to be testamentary.

VI. REFUND ANNUITY CONTRACTS PRIVATELY PURCHASED

People v. Schallerer has been described as a "case of first impression
in Illinois." The annuity contracts concerned provided for a fixed

39. Id. at 502, 144 A.2d at 315.
40. 145 Conn. 497, 144 A.2d 312 (1958).
43. 12 Ill. 2d 240, 145 N.E.2d 585 (1957).
44. Id. at 244, 145 N.E.2d at 587.
annual stipend for a definite period of time or for so long as the annuitant should live, with a provision that if he died before receiving the stipulated amount, i.e., the purchase price of the contract plus interest, then the difference between that sum and the annuities received was to be paid to a named beneficiary of the annuitant. The issue was whether the balance remaining to be paid on the contract to the named beneficiary constituted a transfer of property "intended to take effect in possession or enjoyment at or after . . . death."

In holding that the proceeds of the refund annuity payable to the named beneficiary were taxable as a transfer intended to take effect in possession or enjoyment at the death of the grantor, the court based its opinion on the transfer of a valuable economic interest over which the donor retained control during his life. In reaching this conclusion, it cited with approval similar cases in other jurisdictions.

VII. STATE AND MUNICIPAL GOVERNMENT RETIREMENT PLANS

It has been noted previously that a survivorship annuity was held subject to inheritance taxation in *In the Matter of Estate of Endemann*, and further that in that case the decedent Endemann was a member of the New York City retirement system. Ordinarily, retirement plans created by state or municipal governments embrace two fundamental concepts so far as taxation is concerned: first, most governmental retirement plans call for contribution by the employee as well as by the employer, and it is not unlikely that the employee may make the more substantial contribution; and second, statutes creating state or municipal retirement plans usually contain comprehensive provisions exempting the proceeds of the plan from levy, garnishment, attachment, and other legal process, and from all state and local taxation.

The State of New York, as indicated by *Endemann*, is one of the few

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47. See note 29 supra and accompanying text. *Endemann* has been cited by various New York Surrogate's Court opinions as controlling the taxability of survivorship annuities. See, e.g., *In re Harbord's Estate*, 132 N.Y.S.2d 647 (Sur. Ct. 1954).
48. The Virginia exemption, which is typical of state legislation exempting such proceeds, is applicable to the Virginia Supplemental Retirement System and reads as follows: "Retirement allowances and other benefits accrued or accruing to any person under the provisions of this chapter, and the assets of the retirement system created under this chapter, are hereby exempted from any State, county, or municipal tax, and shall not be subject to execution, attachment, garnishment. . . ." Va. Code Ann. § 51-111.15 (1958).
jurisdictions which has amended its constitution so that all retirement benefits (except pensions, which are actually gratuities) are subject to state taxation.\textsuperscript{49} Thus, so far as New York is concerned, all doubt as to the applicability of an exemption from taxation for state and municipal employees' retirement proceeds is removed. No special benefit is extended to any particular class of employees.

In California, the County Employees Retirement Law\textsuperscript{50} originally provided a general exemption from taxation for retirement allowances. This statute was construed in \textit{Matter of Estate of Simpson},\textsuperscript{51} a case concerning the Los Angeles County Employees' Retirement Fund. The decedent died prior to retirement, designating his wife as beneficiary under the fund. Accordingly, the widow eventually received $15,856.26, of which $7,676.42 represented a return of contributions paid by decedent to the retirement fund. The sole question in the case was whether the payment received by the widow was exempt from inheritance taxation under the general exemption provisions in the law.

The court held the death benefits taxable and the contended exemption inapplicable on the theory that where a statute provides for specific exceptions from the operation of another statute, general in its terms, the exceptions must be strictly construed, and thus any doubt as to a right of exemption must be resolved against the exemption. The court, therefore, upheld the Controller's contention that the statutory exemption under section 31452 was applicable to property taxation but not to inheritance taxation.

The California legislature apparently took note of this decision, for the statute was amended the following year specifically to exempt from inheritance taxation the retirement allowances of county employees,\textsuperscript{52} thereby expressly overruling the \textit{Simpson} result. Thus, while New York, by constitutional amendment, allows state inheritance taxation of local or state government retirement plans, California specifically exempts such benefits. This demonstrates the necessity for careful scrutiny of the particular state constitution and statutes when confronted with the issue of state inheritance taxation, especially of municipal or state retirement plans.

\textsuperscript{49} NY. Const. art. XVI, § 5; see note 32 supra.

\textsuperscript{50} "The right of a person to a pension, annuity, retirement allowance, return of contributions . . . [is] exempt from taxation, whether state, county, municipal, or district . . ." Cal. Sess. Laws 1947, ch. 424, § 1, as amended, Cal. Sess. Laws 1949, ch. 199, § 1.

\textsuperscript{51} 43 Cal. 2d 594, 275 P.2d 467 (1954).

\textsuperscript{52} "The right of a person to a pension, annuity, retirement allowance, return of contributions . . . [is] exempt from taxation, including any inheritance tax, whether state, county, municipal, or district. . ." Cal. Gov't Code § 31452.
VIII. UNITED STATES GOVERNMENT RETIREMENT PLANS AND UNITED STATES CIVIL SERVICE BENEFITS

Whether benefits paid under the Civil Service Retirement Act of 1956 are subject to state inheritance taxation depends upon the nature of the benefit. There are at least six different types of payments made under the act. One of the benefits provides for an annuity to become payable to the surviving spouse of a deceased federal government employee, where the death of the employee occurs after five years of federal service, but prior to retirement of the employee.\(^\text{54}\)

Efforts to impose a state inheritance tax on an annuity payable to the widow of a nonretired federal employee, whose death occurs after five years of federal service, have been successfully resisted by the widow in at least two jurisdictions. In \textit{Capps v. District of Columbia},\(^\text{55}\) the decedent was a United States Government civil service employee for over forty-one years. He was not retired at the time of his death, and the total credit in his account with the Civil Service Commission was $9,301.13. Upon his death the widow received an annuity of $188 per month for her lifetime or until her remarriage. No part of the annuity was included in the inheritance tax return filed with the District Assessor. Upon assessment of an inheritance tax deficiency, the taxpayer paid the tax and filed an application for refund.

The Board of Tax Appeals determined that the widow received her annuity as a result of a 1954 amendment to the Civil Service Retirement Act, providing for the first time that widows of those federal employees who died while in active service should receive annuities.\(^\text{56}\) This was a right, not transferred from the decedent, but created by statute; therefore the court granted the petitioner the refund she sought. The fact that the decedent possessed certain rights under the Civil Service Retirement Act which he declined to exercise during his lifetime, did not bring these rights within the purview of the inheritance tax laws. Such rights, said the court, were extinguished at the moment of the death of the decedent, and nothing further passed at his death by reason of their prior existence.

\textit{In re Estate of Sweet}\(^\text{57}\) reached the same result as \textit{Capps}, in an identical fact situation, but without the assistance of the \textit{Capps} decision, which was not cited in either the majority or the dissenting opinion. The Wisconsin Department of Taxation included in the decedent's gross

\(^{57}\) 270 Wis. 256, 70 N.W.2d 645 (1955).
estate, as a transfer intended to take effect in possession upon the employee's death, the present worth of annuity benefits payable to the widow of a deceased federal government employee, actively employed at the time of his death.

The majority opinion, holding the annuity not taxable under the Wisconsin Inheritance Tax Act, relied on a 1910 Wisconsin decision dealing apparently with the taxation of insurance policies in an inter vivos trust, and upon certain decisions of New York courts rendered after the adoption of the Wisconsin act, which was modeled on the New York statute.

The vigorous dissenting opinion would have held the annuity benefits taxable under the statute, and cited as authority Borchard v. Connelly, In re Brackett's Estate, Cruthers v. Neeld, In re Estate of Daniel, and In re Dorsey's Estate. The dissent concluded:

It might be argued that these cases are distinguishable from the case at bar because the employees in those cases possessed the right to designate the beneficiary. We do not consider the lack of any right on the part of the employee to name or change the beneficiary prevents a taxable transfer occurring. It is the performing of services by the employee under terms of employment calling for the payment of the annuity to the beneficiary upon death that constitutes the acts on the part of the employee which effects the transfer.

Earlier, the dissent had stated:

The employee by voluntarily rendering services for the federal government under the terms of employment heretofore described performed the acts which effected the transfer to his widow. The part of his salary withheld to fund the annuity stands in the same category as if he had been paid his salary in full and from such payments he had therefrom paid back to the government the amount of his share of the contributions. The additional contributions made into the fund by the government were in no sense a gift or gratuity by the government but constituted in effect additional compensation for the services the employee performed and were in direct ratio to such services measured in dollars of salary earned.

61. 140 Conn. 491, 101 A.2d 497 (1953).
64. 159 Ohio St. 109, 111 N.E.2d 232 (1953).
66. 270 Wis. at 264-65, 70 N.W.2d at 650 (dissenting opinion).
67. Id. at 264, 70 N.W.2d at 650 (dissenting opinion).
Such reasoning also finds support in *Miller v. Commissioner* where it was stated that a civil service employee, who has a right to receive an annuity upon retirement and to receive a return of the amount withheld from his salary with interest upon separation or death, has a vested right under the Civil Service Retirement Act.

If the majority of the court in *Sweet* side-stepped the main issue in the case by relying on a former decision which apparently was not in point, the vigorous dissenting opinion may be said to have gone too far in order to sustain taxation. The dissenting justices were clear in that they would be inclined to hold that the mere performance of services by the employee under the terms of his employment was sufficient to constitute a transfer intended to take effect in possession or enjoyment at or after the death of the grantor. It is submitted that none of the leading cases cited by the dissenting opinion go quite this far. In each instance the flow of economic benefits to the surviving annuitant was due to something in addition to the deceased employee's contract of employment; namely, the specific designation by the deceased employee of the surviving annuitant. In *Sweet*, the surviving annuitant was not designated by the decedent. Her designation as an annuitant was a result of the statutory terms governing her husband's employment with the federal government. Under the facts of that case, and under the applicable provisions of the Civil Service Retirement Act, Mr. Sweet did not possess the right to prevent the annuity from going to his widow. She was the statutory beneficiary. Had Mr. Sweet lived and retired under the applicable provisions of the statute, he could then have made certain elections which would have defeated entirely any benefits to Mrs. Sweet. On the other hand, had Mr. Sweet lived to retirement, he could have elected to receive a reduced annuity for himself, and a survivorship annuity for his spouse, should she survive him. The election by a retired federal employee of a reduced annuity, and the payment of a survivorship annuity to a designated beneficiary under the Civil Service Retirement Act would clearly create a situation identical to that in the leading cases cited by the dissent; that is, a transfer of property intended to take effect in

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68. 144 F.2d 287 (4th Cir. 1944). This case was not cited in *Sweet*.
possession or enjoyment at the death of the employee and, hence, ordinarily taxable.

The rationale of the dissenting opinion, if carried to its logical conclusion, would include in a decedent's estate annuities payable under the Social Security laws and under the Railroad Retirement laws, since under those statutes also, an employee possesses no right to change the beneficiary designated by the statute. Yet no recorded cases are available in which the social security annuity has been includible in a decedent's gross estate as a transfer intended to take effect in possession or enjoyment at the death of the employee.

Unfortunately, the reasoning of the District of Columbia Board of Tax Appeals decision in *Capps* is in accord with neither the majority nor the dissent in *Sweet*. The facts in the two cases are identical, and the annuity payable to the surviving spouse in each case was paid to her as the statutory beneficiary under the Civil Service Retirement Act, rather than as the beneficiary designated by the decedent. In seeking to establish and maintain tax liability, the District Assessor made much argument of the fact that the decedent was entitled to retire, and that if he had retired, he could have elected to exercise rights which might have resulted in his estate's becoming the beneficiary of certain funds, or might have resulted in a reduced survivorship annuity to his surviving spouse. The Board of Tax Appeals, however, noted that it is not the unexercised rights of the decedent which are taxable under the statute, but rather the transfer of property.

The effect of *Sweet*, however, was subsequently limited and distinguished by the Wisconsin court's opinion in *In re Estate of Stone.* That case involved the election of a joint and survivorship annuity by the decedent in favor of his wife, if she survived him. The plan was a qualified trusteed plan, and although the decedent was eligible under the plan to retire and receive immediate benefits, he had not done so.

Before the 1962 amendment, a retiring employee had to designate specifically his spouse to receive a survivorship annuity. This designation, or election, constituted a gift or grant to take effect in possession or enjoyment at or after death and, hence, the basis of the jurisdiction to tax the survivor's annuity. The 1962 amendment, however, relieved the retiring federal employee of making the election. Query: Will the absence of the retiring employee's election tend to remove the survivor's annuity from the category of a taxable transfer? The answer is not clear. According to the rationale of the *Capps* case, the unexercised rights of the decedent are not taxable. Further, does it appear that each retiring employee who fails to elect in writing an annuity for himself is thereby providing his surviving spouse with a survivorship annuity "by operation of law"? On the other hand, may the survivor's annuity be includible in the decedent's gross estate because of the "relinquishment of a power to appoint"?

71. 10 Wis. 2d 467, 103 N.W.2d 663 (1960).
The election of the joint and survivor's annuity and the designation of his wife as beneficiary were held to be a transfer of whatever interest the decedent had in the employee’s trust fund, and subject to inheritance taxation as a transfer intended to take effect in possession or enjoyment at death. Sweet was distinguished because Mrs. Sweet became entitled to the annuity by operation of law which controlled the retirement system and not because of any option exercised by the employee in her favor. Thus, Sweet was considered limited to only those benefits which, under the particular retirement plan, were payable to the beneficiary upon the death of the nonretired employee who did not possess any option as to the distribution of benefits.

IX. EMPLOYEE DEATH PAYMENTS

The Internal Revenue Code of 1954 provides a special exclusion from income taxation for certain payments if made to a deceased employee’s beneficiaries by reason of the death of the employee. The payment to the beneficiary need not be made by an express contract. A voluntary payment by the employer qualifies for the exclusion under the Code.

Whether a benefit paid under Section 101(b) of the Internal Revenue Code is subject to state taxation will depend upon the nature of the payment. Is it made by an employer as the result and as a part of a qualified retirement plan? Is it insurance coverage carried by the employer for this specific purpose? Has the employer given an outright gratuity to the deceased employee’s beneficiary? It is necessary to know in what manner and from what funds a death benefit under section 101(b) is paid before the state tax consequence can be determined.

If the payment is made under insurance coverage carried by the employer it will most likely be exempted from inheritance taxation under the general exclusion for life insurance. If the deceased employee, while alive, had no vested rights in the ultimate benefit (as for example, where he was ineligible to meet vesting requirements) and the lump sum benefit is voluntarily paid to his beneficiary, the payment would appear to be in the nature of a gratuity and, hence, not includible in the decedent’s gross estate for inheritance tax purposes.

The gratuity payment, however, contains a pitfall for the employer. He may find himself subject to the state's gift tax statutes in the case of

72. Int. Rev. Code of 1954, § 101(b). This section excludes from gross income (subject to a $5,000 limitation from each employer of the deceased employee) the amounts received, whether in a lump sum or in installments, by the beneficiaries or the estate of an employee, if such amounts are paid by or on behalf of an employer and are paid by reason of the death of the employee.
gratuitous payments made under section 101(b). Twelve states impose state gift taxes,\textsuperscript{73} which usually follow the pattern of the state's inheritance tax laws and are designed to reach all transfers by gift, where the property is within the jurisdiction of the state.

It appears settled in Wisconsin that gratuitous payments to the beneficiary of a deceased employee, not paid according to an established plan for paying company funds as additional compensation or pension benefits, are subject to the state's gift tax laws.\textsuperscript{74} The decisions turn on the fact that the payments are plainly gratuitous in nature, the company having no legal obligation—contractual or otherwise—to make death benefit or pension payments such as these. A gratuitous payment to an employee is, of course, a transfer coming within the scope of gift tax statutes, unless otherwise specifically excluded.

If the payment is made as part of a qualified plan, it would appear to be includible in the deceased employee’s gross estate and subject to inheritance taxation, since the payment would apparently be part of the contractual obligation between employee and employer, in which the employee had acquired some vested rights.

\textsuperscript{73} They are California, Colorado, Louisiana, Minnesota, North Carolina, Oklahoma, Oregon, Rhode Island, Tennessee, Virginia, Washington and Wisconsin. 1 P-H State & Local Tax Serv. \S 101 (1962).

\textsuperscript{74} Spangler v. Wisconsin Dep’t of Taxation, 255 Wis. 51, 37 N.W.2d 857 (1949); Oshkosh Trunks & Luggage Co. v. Wisconsin Dep’t of Taxation, CCH Inh., Est. & Gift Tax Rep. (7th ed.) \S 17225 (Wis. July 26, 1950). Similarly, payments were held to be gifts and not pensions in Brindley v. Wisconsin Dep’t of Taxation, CCH Inh., Est. & Gift Tax Rep. (7th ed.) \S 19191 (Wis. March 17, 1960). In Brindley, the Spangler decision was held to be directly in point. In order for the payments not to constitute gifts, the corporation must have a continuing plan of payment. There must be a sustained and continued obligation. The payment must not be sporadic or result from occasional impulse. In Brindley, the taxpayer failed to show that the transfers resulted from a sustained and continued obligation, or were made under a continuing plan of payment to widows of deceased corporate officers. Boylan-Pearce, Inc. v. Johnson, 257 N.C. 532, 126 S.E.2d 492 (1962), reached a contrary result, but was based on the application of the North Carolina statute. N.C. Gen. Stat. \S 105-147(23) (1958)—provides that in computing net income, “the amount of salary or other compensation of an employee which is paid for a period of not more than twenty-four months after the employee’s death to his estate, widow, or heirs provided such payment is made in recognition of services rendered by the employee prior to his death and is reasonable in amount” would be deductible. In Boylan-Pearce, thirteen months after the death of its president, the family corporation passed resolutions authorizing the payment of $36,000 to the widow of the deceased president. The Commissioner of Revenue required the taxpayer corporation to pay a gift tax and refused to allow a deduction for business expenses. On appeal this ruling was reversed, and the taxpayer was held not liable for gift tax. The question of whether the proceeds constituted income to the widow recipient was not before the court and was therefore left unanswered.
X. VALUATION OF ANNUITY INCLUDIBLE IN DECEDENT’S GROSS ESTATE

Once it is determined that an annuity is subject to state inheritance taxation, the next question is that of valuation for the purpose of including it in the gross estate. This valuation problem was discussed by the court of appeals in the Endemann decision, in which the state calculated the value of the widow’s annuity by estimating the value of an immediate single life annuity for a person aged seventy-three. Endemann was entitled to a choice of several ways to take his annuity. He elected a survivorship annuity that entitled him to an annuity of $3,140.60 for his lifetime, with an annuity of half that amount going to his wife for her lifetime after his death. The choice, once made, was irrevocable. Endemann was seventy-five years of age when he died; his wife was seventy-three. Based on the actuaries’ combined experience table of mortality, with interest at four per cent, the present value of $1.00 due at the end of each year during the life of a person aged seventy-three is $5.45928. Thus the value of Mrs. Endemann’s annuity in the case was calculated at $1,570.20 times $5.45928, or $8,572.16. The inheritance tax on the sum involved was $85.72.

The Surrogate had decided that it was erroneous for the state to value Mrs. Endemann’s annuity as a single life annuity for a person aged seventy-three. Since her rights were those of a surviving annuitant, the court had held that their value must be estimated as of 1947, the date of death of the primary annuitant, Endemann.

The Surrogate’s method of calculation, which was affirmed by the appellate division, had been to compute the value on an initial reserve basis as follows: The decedent had an “initial reserve” in the retirement system of $34,183.04. He took for himself an annual retirement annuity allowance of $3,140.60. As a result of payment of this annuity through the years, the amount of $28,668.60 of the “initial reserve” was consumed. This left a balance in the “initial reserve” of $5,514.44, and this balance constituted the value of the annuity which Endemann arranged for his wife. This was the value at the time of his retirement, to which was applied proportionately the receipt of his annuity, and the balance remaining at the time of his death was the value to the surviving annuitant.

75. 307 N.Y. 100, 120 N.E.2d 514 (1954).
77. Ibid.
78. 282 App. Div. 768, 122 N.Y.S.2d 682 (2d Dep't 1953) (memorandum decision).
79. This calculation of the survivor’s annuity was not expressly set out in the surrogate’s opinion, but was detailed in the appellate division’s memorandum as the valuation which the evidence indicated had been used. Id. at 769, 122 N.Y.S.2d at 684-85.
The court of appeals, however, declined to go along with this method of valuation. In fact, the opposing litigants both agreed that the appellate division's method of valuation could not possibly be correct, since it assumed that a certain proportion of the "initial reserve" was the correctly calculated value of Mrs. Endemann's annuity and there was no proof that the reserve was so calculated. Even if the valuation were assumed to be correct, the court pointed out that this was not the value to be taxed. The thing to be taxed was the value of the transfer, i.e., the annuity, to Mrs. Endemann when she took it. The method of calculating this value is set forth in the New York statute, and the state's appraiser correctly applied it by estimating the value of a single life annuity for a person, age seventy-three. The court concluded by stating that all valuations of prospective future interests must be made on the basis of pure formulae.

A. The Valuation of Annuities for Inheritance Tax Purposes

The inheritance tax, being a tax on the right to receive, is measured by the share of the estate passing to the particular beneficiary. Therefore, it is the value of the annuity to the survivor when the survivor takes which is properly the subject of the inheritance tax. As a practical matter, this valuation may be determined in one of two ways: first, as the present value of $1.00 based on the actuaries' combined experience table, due at the end of each year during the life of a person of a certain age. This was New York's method of calculation, finally affirmed in Endemann. It has the advantage of simplicity, and it is fairly precise when measured in terms of what the surviving annuitant is entitled to. Many inheritance tax jurisdictions provide by statute, or by administrative regulation, for the use of the actuaries' combined experience table, or other mortality table, in calculating the valuation of any annuity, including a survivorship annuity. The interest rate upon which the actuaries' combined experience tables of mortality (or tables of "present values") are based, varies from state to state, and this may cause the value for an annuitant of the same age to vary slightly, but not significantly. The second method of determining the value of the survivorship annuity is by reference to the sale of a comparable contract by a company engaged in the business of selling contracts of a similar nature. In other words, how much would an insurance company have charged

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80. N.Y. Tax Law § 249-v.
Mrs. Endemann for an annuity providing for the payment of $1,570.20 annually for her life at age seventy-three? This method of valuation is cited with approval in the Federal Estate Tax Regulations, but while the citation there concerns a survivorship contract, it does not involve a contract whereby the value of the annuity is attributable to contributions made by the decedent's employer, either under a "qualified" plan or otherwise. California provides that in the case of a commercial annuity contract, issued by a company regularly engaged in the business of selling such contracts, the value of the annuity is ordinarily the cost of the contract, but, in the case of an annuity created by will or trust instrument (not a commercial annuity), the value is to be determined by reference to the actuaries' combined experience table of mortality.

B. Conflicting Problems of Basis on Account of Conflicting Estate Valuations

Because of the fundamental differences in the application of the states' inheritance tax laws, as compared with the federal estate tax law, it is a fairly simple matter to foresee that a beneficiary may receive from an estate property which will take two separate and distinct "bases"—one for future federal gains or losses and one for future state gains and losses. It is incongruous that the states should use one method of valuation and the federal government another, when subjecting the identical property to inheritance and estate taxation. Yet this is an everyday occurrence, particularly in the valuation of annuities for death tax purposes. With the exception of those states which have adopted the amount of the Federal State Death Tax Credit allowable under Section 2011 of the Internal Revenue Code of 1954 as their inheritance or estate tax, few states have adopted the federal rule for determining the valuation of an annuity as set out under sections 2039(b) and 2039(c) of the Code. Consequently, the recipient of a survivorship annuity from a decedent must frequently look forward to the necessity of maintaining two sets of income and basis (or cost) records for the future. The surviving annuitant will, for state income tax purposes, be deemed to take as her basis (or cost) the value of the annuity on the date of death of the primary annuitant; that is, the value calculated for the state inheritance tax purposes. Until this basis is recovered, the surviving annuitant need not be concerned with the state's income tax on the proceeds of the annuity.

The inconsistency of two taxing authorities placing different valuations on the identical property subjects the taxpayer to an unfair com-

pliance burden. It is no excuse to say that this compliance burden is not all-inclusive, since it affects taxpayers in only half of the fifty states. Taxpayers similarly situated with identical factual situations deserve similar tax treatment.

It would appear that the solution to this inconsistency would be accomplished through the states’ adoption of the federal method of valuation of employee annuities in the case of those estates which come within the purview of the federal estate tax law, and which contain annuities includible in the decedent’s gross estate. This is not to imply that a state should imitate the federal statute, nor that the state should relinquish any of its sovereignty in fiscal matters. Uniformity of taxation and tax treatment as an equitable and desirable fiscal characteristic may be achieved without consequential loss of state revenue, by employing the method of calculation used by the federal taxing authorities in specific instances and applicable to specific property. The state need not adopt the federal statute on the complex questions of annuity taxation; the method of calculating the valuation of the asset to be included in the decedent’s estate is sufficient for state purposes, and uniformity may be achieved by the adoption, by reference, of the provisions of those sections of the Internal Revenue Code and Treasury Regulations which provide for calculating the valuation includible in the gross estate.

Uniformity of treatment of taxpayers would dictate that the same method of calculation be applied to all estates subject to the state’s inheritance tax laws, regardless of whether the size of the estate comes within the purview of the federal estate tax laws. In fact, the mortality tables used by the states for inheritance and gift tax purposes are so diverse that, in the interest of uniformity, the state tax administrators themselves have urged the enactment of state legislation to adopt the methods, tables, and discount rates employed by the federal government in determining the value of future estates.

An unusual case relating to valuation of the death benefit includible in the decedent’s estate is People v. Bejarano. There, the decedent was employed for over thirty years, most of the time in California and for a shorter period in Texas. While living and working in those states, he made contributions from his salary to a company-administered pension

85. The duplicity of basis does not exist in those states which assess the federal-state death tax credit as their estate tax; nor does it exist in any of the seventeen states which do not have an individual income tax. Of course, it does not occur unless the decedent’s gross estate is of sufficient size to come within the purview of the Federal Estate Tax Law.

86. Resolution No. 11 of those adopted at the 28th annual meeting of the National Association of Tax Administrators held at Minneapolis, June 13-15, 1960.

trust. The employer's contributions were slightly in excess of the decedent's. The pension trust provided that after five years of employment the employee was to become entitled to all contributions plus earnings. Upon the employee's death, the entire amount of contributions, together with earnings, would go to the employee's beneficiary to the extent that she was entitled to them. Both California and Texas are community property states. The decedent died a resident of Colorado. The Inheritance Tax Commissioner of Colorado sought to tax one half of the proceeds of the pension trust. The decedent's spouse objected on the grounds that the proceeds in question had been accumulated in community property states and that her share was a present vested interest at the time of accumulation. The state argued that the nature of Mrs. Bejarano's interest in the community property was one which, by its nature, under the laws of California and Texas, postponed its possession and enjoyment until the death of the husband.

The court held that for tax purposes the interest in the property had previously vested in Mrs. Bejarano. Therefore, the funds were not subject to inheritance tax assessments. The contributions by the decedent were his earnings and had the quality and character of community property when deposited into the pension trust fund. After deposit, the fund retained its community character, even when it or the parties were removed to a common law state. Hence, since Mrs. Bejarano had vested rights in the earnings of her husband at the outset, those rights were entitled to subsequent recognition. Further, the court declined to accept the Inheritance Tax Commissioner's contention that the election of the decedent to participate in the retirement fund plan furnished the essential act of decedent, constituting a gift or grant intended to take effect in possession or enjoyment at death.

Since the court was persuaded to the view that Mrs. Bejarano acquired vested rights at the outset, it did not consider the Inheritance Tax Commissioner's argument that the wife's interest in the community property was less than a full vested right. Thus, the failure of the noncommunity property jurisdiction to consider statutes and decisions of the community property jurisdiction in which the property interest, if any, was acquired, resulted in the allowance of greater property rights than would have been allowed in the community property jurisdiction itself.

XI. SUMMARY AND COMMENT

The general tenor of the state court decisions is to hold taxable the death benefits payable under ordinary pension and profit sharing plans. Death is considered the generating source or operative event which
brings into effect the applicable inheritance tax statute, providing that a grant or gift intended to take effect in possession or enjoyment at or after the death of the grantor or donor constitutes a taxable transfer. The employee is considered vested with a present, fixed right to a future enjoyment. If the employee does not live to enjoy his retirement benefits, the economic interest with which he is vested passes at his death to designated beneficiaries.

If the courts show any tendency to shy away from a holding of taxability in the case of these benefits, it is because of the troublesome question of vesting. When, if ever, does the employee acquire a vested interest in the plan? How much vested interest in the employee is necessary in order to bring the transfer within the purview of the taxing statute? Can there be “varying degrees of vesting”? These are matters which apparently give the courts much concern. Is an employee, who is vested with a present fixed right to a future enjoyment, possessed of as great a property right or economic interest as the employee who is vested with an immediate right to a present enjoyment? Apparently he is, at least for purposes of inheritance taxes, and the decisions in Dorsey and Daniel seem clearly to hold that vesting features which result in the acquisition of valuable property rights make the benefits taxable.

Most plans give the employee a vested interest in varying degrees. If an employee terminates his service after a certain number of years, prior to retirement or death, he may be entitled to withdraw some portion of the fund deposited to his credit. Liberality of the vesting features is dependent upon the employer's policy, experience with employee turnover, and other incentive factors. In the case of most plans, the employer parts with his interest in the fund and it is held for the benefit of the employee. The employee's interest has been compared to the interest of a participant in a spendthrift trust, where there is no right to alienate the corpus during the period of the trust.

Somehow, the courts do not seem to be concerned with the source of contribution to the plan. The Daniel case involved a combined pension and profit sharing plan whose funds were provided entirely by employer contributions; yet the noncontributory feature did not cause any concern to the majority of the court. Of course, it is obvious that a profit sharing plan, by its very nature, calls for contribution by the employer from annual profits only, and there is no fixed or predetermined amount of contribution except from annual profits; therefore, no definite amount can be set aside as the retirement benefit until the determination of.

89. 159 Ohio St. 109, 111 N.E.2d 252 (1953).
annual profits, if any. Consequently, whether a plan is contributory or noncontributory does not appear to be a relevant consideration.

In summary then, the rationale of the courts appears to be pitched upon one or several of the following considerations: *first*, that the decedent owned or possessed a sufficient property right; *second*, that there was a definite or substantial economic benefit which passed from the employer to the deceased employee's beneficiaries as a result of his participation in the plan; *third*, that the employee's beneficiaries are third party beneficiaries to the retirement contract between employer and employee.

The argument against inheritance taxation of the death benefits payable under typical plans, as advanced by the decedent's beneficiary or his personal representative, seems to take one or several of the following forms: *first*, that there is a lack of a sufficient property right in the decedent because of his inability to reduce the fund to actual possession or enjoyment until his retirement from employment; *second*, that there is a lack of a sufficient property right because the sole source of contributions is the employer, or that the plan designated the beneficiary, so that as far as the employee is concerned, the plan is noncontributory and nondesignatory, and he is not vested with any property interest; *third*, that the death benefit is comparable to insurance proceeds which are generally excluded from inheritance taxation by most states.

In the absence of a statute providing for a specific exemption for employee death benefits payable under retirement plans, the state court decisions holding such benefits subject to inheritance taxation as a gift or grant intended to take effect at or after death, appear clearly correct and justifiable. Whether it is desirable to exclude such benefits from the state tax base is a matter of legislative policy rather than of judicial sanction. If taxing statutes are to be construed and applied in a fair

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90. In Estate of Stone, 10 Wis. 2d 467, 103 N.W.2d 663 (1960), the court held that the decedent's interest in the employees' trust, although defeasible upon certain contingencies, constituted a sufficient interest in property. The contingency was the employer's reservation of the right to terminate or amend the plan, but in the event of termination, there was no reversion to the company. Therefore, an interest under a retirement plan is property, notwithstanding the reservation by the employer of the right to terminate or amend the plan.


92. See, e.g., Dolak v. Tax Com'r, 145 Conn. 497, 144 A.2d 312 (1958).

93. See, e.g., In re Estate of Daniel, 159 Ohio St. 109, 111 N.E.2d 252 (1953).

94. See, e.g., In re Estate of Sweet, 270 Wis. 256, 70 N.W.2d 645 (1955).

95. This argument against taxability appears fairly well rejected by the courts. It was advocated strenuously but to no avail in Cruthers v. Neeld, 14 N.J. 497, 103 A.2d 153 (1954), and In the Matter of Estate of Clark, 10 Utah 2d 427, 354 P.2d 112 (1960).
STATE TAXATION

manner to the taxpayer so as to achieve equal and uniform application among all taxpayers, then the employee who provides a survivorship annuity for his spouse, as a result of the creation of a pension plan, should certainly not enjoy any tax advantage over the employee who undertakes to accomplish the same result without the aid of his employer. If the end result is a survivorship annuity, then each deceased employee's benefits should be subjected to inclusion in the same tax base. This would insure equality of application and provide the state with a comprehensive tax base.

PART TWO: STATE INCOME TAXATION OF RETIREMENT BENEFIT PAYMENTS

From the outset it should be noted that fifteen states do not tax non-business individual income. Among the remaining states the extent of the imposition of an individual income tax differs considerably, although practically every state has attempted in varying degrees to align its income tax system with the Internal Revenue Code of 1954. However, the inherent difference between the sovereign powers of the states and those of the federal government with respect to their constitutional authority to levy an income tax has precluded complete success in achieving state-federal income tax uniformity, and consequently, in many instances, such attempts have been abandoned. Moreover, among the states themselves, there is a lack of uniformity in taxing individual income. Nowhere is this more apparent than in the field of retirement benefit taxation.

The various states have tailored their respective tax systems to meet particular fiscal and political needs, by broadening the tax base in accordance with these requirements. The result has been that the states have included in, or excluded from, gross income certain retirement payments only after giving due consideration to their constitutional authority to do so. Thus, it is difficult to state categorically what treatment will be given to a particular type of retirement income. An attempt will be

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made, however, to define broadly the tax treatment accorded such payments, with the caveat that notable differences exist among the states.

I. COMMERCIAL ANNUITIES

The purchase of a commercial annuity is a means whereby an individual can provide for continuity of income for himself and his family after reaching a given age. The amounts received as payments under an annuity contract consist of two elements. A part of the payment is merely the return on the investment in the annuity; the remainder is the increment in value of the amount so invested. Consequently, the amount which the annuitant receives in excess of his cost basis is taxed as income. Both the federal government and the states tax the income portion of the payments in excess of the original investment, but the method of taxation imposed by each differs. Neither the federal government nor the states, however, tax the annuity income as it accrues, but defer the tax until payments are actually received or are made available to the annuitant or other designated beneficiary.

The states follow three basic patterns in taxing annuity payments. The first pattern utilized is to exempt all payments from income until the original cost has been recovered. Accordingly, annuity payments are income only to the extent of payments received after the aggregate premiums (income tax cost) have been recovered. Under this system, the annuitant is given a significant tax benefit insofar as the tax is deferred until after his cost is recouped. This benefit is offset, however, when the annuitant lives beyond his normal or annuity life expectancy because the full amount of such payments, after recovery of his cost, becomes taxable. The annuitant can, of course, receive some fiscal satisfaction from the fact that his total taxable income, and consequently his tax rate, is generally lower in the later years of his life. Moreover, he has outlived the actuarial date of his expected demise and is reaping extra interest on his investment.

It should be noted, however, that in those states which use this scheme for taxing annuity payments, if the annuity contract provides for the separation of payments into principal and interest, the interest is taxed when received regardless of whether the cost has been recovered or not. As a result, the tax deferment benefit does not inure to the taxpayer.

The second tax pattern, commonly referred to as the "three per cent rule," operates as follows: If an annuity is payable in annual install-
ments, only that portion of the amount received in any taxable year equal to three per cent of the aggregate premiums paid by the annuitant, whether or not paid during the taxable year, is included in gross income. Conversely, the portion of each installment received in any taxable year in excess of three per cent of the aggregate premiums, divided by twelve and multiplied by the number of months for which the installment is paid, is not included in gross income. When the aggregate of the amounts received and excluded from gross income equals the aggregate premiums paid for the annuity, the entire amount received thereafter in each taxable year is included in gross income.\textsuperscript{80} If installment payments are received on a monthly or other basis, the payments are appropriately prorated.

Where amounts are paid under a joint and survivor’s annuity, the value of any part of the survivor’s interest must be included in the gross estate for state inheritance or estate tax purposes. The basis or cost of such interest to the survivor annuitant is considered to be the value of the life annuity at the time of the decedent’s death. Such valuation is substituted, as of the date of the first annuitant, for the consideration previously used for purposes of determining the taxable amounts of the annuity payments received after the death of the deceased annuitant. With respect to the survivor annuity payments made after the death of the first annuitant, the amount of the consideration, determined in accordance with the rule, must be substituted for the consideration that may be recovered without inclusion in gross income.

The third basic state annuity tax pattern is generally referred to as the “federal rule.”\textsuperscript{100} Briefly, this rule provides for the exclusion of a portion of each payment from gross income. The method of exclusion is prescribed by the so-called “exclusion ratio” formula, which is equal to the amount which the investment in the contract bears to the expected return as of the annuity starting date.\textsuperscript{101} Ordinarily, once the exclusion

\textsuperscript{99} For example, if the taxpayer purchases an annuity for $50,000 which is payable $5,000 per year, $1,500 or 3\% of $50,000 is taxed as gross income and $3,500 is exempt. As soon as the tax exempt payments equal $50,000, the full amount of the $5,000 annual payment becomes taxable.


\textsuperscript{101} For example, if as of the annuity starting date, the taxpayer’s investment is $7,700 and his expected return is $12,000, his exclusion ratio would be 7,700/12,000 or 64.2\%. If
is computed, it will remain constant even though the annuitant outlives his life expectancy. Therefore, under the federal rule, it is possible for the annuitant to recover, tax free, an amount greater than his original investment in the annuity contract.\textsuperscript{102} It should also be noted that under the federal rule, the exclusion ratio does not change regardless of the type of annuity involved. Consequently, where a joint and survivor annuity is involved, the exclusion ratio used by the primary annuitant is also used by the survivor annuitant after the former's death.

The federal regulations set forth rather specific definitions and examples of the technical terms "investment in the contract,"\textsuperscript{103} "expected return,"\textsuperscript{104} "exclusion ratio" and "annuity starting date."\textsuperscript{105} Hence, reference should be made thereto for a more detailed discussion of these terms and of the other technical rules and regulations governing the taxation of commercial annuities.

Thus, it is readily seen that while the state income tax statutes permit the annuitant to recoup his investment tax free, an effort is made to tax any increment. The three basic rules set forth above appear to be equitable, but only the first seems to give mathematical certainty, and this at the state's expense of granting a tax deferment benefit.

\section*{II. INDUSTRIAL RETIREMENT PLANS}

In recent years, there has been a large increase in the number of qualified pension, profit sharing and retirement plans adopted by industry. Unquestionably, the highly favorable income tax treatment afforded such plans by the federal government is responsible in a large measure for this increase. Among the numerous federal income tax benefits resulting from the adoption of qualified pension or profit sharing plans are the following: (1) the plan is permitted to produce and accumulate income without the imposition of a tax;\textsuperscript{106} (2) the employer is entitled to a deduction, within specified limits, for his contribution to the plan when made;\textsuperscript{107} (3) the employee is not presently taxed on the amount of the employer's contribution credited to his account;\textsuperscript{108} and (4) if by reason of the employee's death or other termination of his employment

\begin{footnotesize}
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\item\footnotesize See Treas. Reg. § 1.72-6 (1956).
\item\footnotesize Treas. Reg. § 1.72-6 (1956).
\item\footnotesize Treas. Reg. § 1.72-5 (1956).
\item\footnotesize Treas. Reg. § 1.72-4(b) (1956).
\item\footnotesize Int. Rev. Code of 1954, §§ 501(a)-(b).
\item\footnotesize Int. Rev. Code of 1954, § 404.
\end{enumerate}
\end{footnotesize}
the total distribution is made within one taxable year to the recipient, the amount in excess of the total contribution by the employee is taxed at capital gains rates rather than at ordinary income rates. Accordingly, there is little wonder that these retirement plans have increased in number so rapidly over the past few years. Their popularity, however, has not gone unnoticed by the states, for many have adopted legislation affording them favorable tax treatment similar to that of the federal government. The desired benefits have been accomplished either by enacting legislation similar to Sections 401-04 of the Internal Revenue Code, or merely by incorporating the relevant Code sections by reference. It is interesting to note, however, that despite the similarity to the federal laws, the state statutes vary the tax treatment of such payments.

Virginia, Louisiana, Maryland and Wisconsin do not impose a tax until payments under the plan exceed the employee’s contributions. However, the appropriate Virginia and Maryland provisions, failing to distinguish between ordinary income and capital gains do not provide for capital gains treatment for lump sum payments.

California and Georgia, on the other hand, while extending the same favorable tax treatment to such plans, apply the three per cent rule to payments received or made available to the employee or distributee. The Georgia regulations provide that if the employee receives payment in installments, such portion of the installment payment not in excess of three per cent of the aggregate contributions paid by the employee, is taxed as income. Consequently, if the employee made no contributions to the plan, the funds being contributed solely by the employer, the payments are fully taxable in the year received or accrued.

Kansas, on the other hand, has adopted legislation which follows the applicable sections of the Internal Revenue Code and the Treasury Regulations. Accordingly, employees are not taxed on amounts con-

tributed by their employers to qualified plans until such time as the amounts are actually distributed or made available to them. Where the proceeds are distributed to employees or their beneficiaries in periodic payments, the recipient is taxed at ordinary income rates. If the employee made contributions, or was taxed for any reason when contributions were made for him, these periodic distributions are taxed as income under the annuity contract, with the employee's contributions being considered the cost of the annuity to be recovered tax free. This treatment applies whether distributions are made under a trust or under annuity contracts. Since Kansas also distinguishes between ordinary income and capital gains, the recipient is permitted to report as capital gains the taxable portion of the sum received by reason of the employee's death or other termination of his employment, if it represents a complete withdrawal of sums due him and is received within his taxable year. Insofar as New York has adopted federal adjusted gross income as the basis of state income tax, the federal treatment of income from stock bonus, pension and profit sharing plans and annuities also has been followed.

III. STATE AND MUNICIPAL PENSIONS

State and local governments have adopted a variety of pension and retirement plans for their employees. The benefit payments received from such plans have either been taxed or exempted from state income taxation in an almost equal variety of ways. In each instance, careful consideration must be given to the legislation adopting the particular plan as well as to the applicable statutes pertaining to taxation of payments received therefrom. The taxpayer's attention should first be directed to the act creating the retirement plan to ascertain whether it exempts payments received thereunder from taxation. For example, amounts received under the Georgia State Teachers Retirement Act and State Employees System are specifically excluded from state income the Kansas State Income Tax Department follows the federal law in regard to the deductibility of amounts paid by an employer to a stock bonus, pension or profit sharing plan exclusively for the benefit of employees. Pending legislative action or court decision interpreting the law to the contrary, the Kansas State Income Tax Department will recognize such pension plans where approved by the federal government. Amounts paid by an employee to such a fund are not deductible.

118. Generally, the tax cost of the annuity is prorated over the remaining life expectancy of the recipient, measured from the date of the first distribution, or, where payments have been received prior to 1954, measured from January 1, 1954. See note 101 supra and accompanying text.


120. N.Y. Tax Law § 612(a).
Accordingly, the Wisconsin Department of Taxation has stated in a letter that in determining the exemption status of retirement benefits paid to state employees it is necessary to look to the particular retirement law under which the benefits are being paid. If the particular retirement act fails to exempt the payment from state income taxation, however, the taxpayer must look elsewhere for authority to exclude it from gross income. Such exemption may be found in the state constitution as is the case in the New York Constitution which provides:

All salaries, wages and other compensation, except pensions, paid to officers and employees of the state and its subdivisions and agencies shall be subject to taxation.

Other states such as Virginia have exempted various types of state and municipal retirement payments from taxation by passing special statutes. Maryland, on the other hand, taxes at ordinary income rates the retirement pay of state and local employees and teachers, where such payments are for past services and based on length of service.

In order to properly report his or her taxable income, the taxpayer must be careful to distinguish between the types of retirement pay which he receives, particularly where such payments are combined. For example, a Maryland teacher who upon retiring receives annual payments of $1,500, part of which is for an annuity to which she contributed $3,000, and part of which is a pension payment, must first determine the exact amount of each type of payment. Assuming $700 is received from the annuity and $800 from the pension, the $1,500 will be taxed as follows: (1) three per cent of the $3,000 invested in the annuity or $90 is taxable as investment income; (2) the $800 received under the pension is taxable at ordinary income rates. In this example it will be noted that the annuity reserve is being reduced each year at the rate of $610 ($700 - $90). In less than five years, the annuity reserve will be exhausted and the entire retirement payment of $1,500 will be taxable.

Similarly, combined payments will be partially taxable in those states which exempt state and municipal retirement payments, but tax annuity payments under either the three per cent rule, the federal rule, or the rule employed in Virginia will not be taxed until the entire amount

122. Letter From the Wisconsin Dep't of Taxation, July 28, 1948, in 1 CCH State Tax Cas. Rep. Wis. ¶ 10-709-60.
123. N.Y. Const. art. XVI, § 5. (Emphasis added.)
contributed by the employee is recovered. It is for the taxpayer to apply the appropriate rule of his or her state.

IV. MILITARY PENSIONS, RETIREMENT AND DISABILITY PAY

In order to determine the tax status of military pensions and retirement payments for state income tax purposes, it is necessary to understand the difference between these two types of payments and the principles underlying each. While both result from the employer-employee relationship, military pensions are gratuities or honorariums in recognition of, but not in payment for, past services. On the other hand, retirement pay is payment for past services and is a kind of deferred compensation for these services.\(^{126}\) Therein lies the basic difference.

Generally, pension payments received from the United States, or from one of the states on account of service in the armed forces, whether such were rendered by the recipient or by a relative, are not to be included in the recipient's gross income.\(^{127}\) Whenever a government, by appropriate legislative action, authorizes the payment of a pension, it is usually designated as such in the legislative enactment. Accordingly, reference to such legislation should be made to determine the type of payment and its consequent tax treatment.

Retirement payments on account of military service are generally subject to state income taxation.\(^{128}\) Since military personnel retired from active duty are still in the service in that they are subject to being called to active duty in the case of an emergency, such payments are regarded not only as compensation for services previously rendered, but also as compensation for awaiting orders in the event an emergency necessitates their recall to active duty.\(^{129}\) Thus, retirement pay is part deferred compensation for services previously rendered and part compensation for services presently being rendered. As such, it is subject to state income taxation, although some states have enacted a "military pay exclusion" provision which exempts a portion of the payment from


\(^{129}\) See note 125 supra.
taxation. Military retirement pay, however, should be carefully distinguished from annuities or other similar allowances received for personal injuries or sickness resulting from active military service. Such payments are considered gifts or gratuities in much the same way that pensions are, and as such, are not subject to state income taxation. Actually, these are not technically gifts or compensation for services rendered but are in the nature of compensatory damages for personal injuries or disability sustained while performing services. This exemption applies also to the beneficiary of a deceased service member.

V. SOCIAL SECURITY BENEFITS

Under the various social security acts, employees are entitled to receive several types of benefit and retirement payments. However, the two principal kinds of payments are unemployment compensation and old age survivors insurance. Both are financed by taxes collected under the Federal Unemployment Tax Act and the Federal Insurance Contributions Act. The employer pays the tax necessary to finance the unemployment compensation program, while both the employer and employee contribute, in the form of taxes, to the old age survivors insurance program.

The tax paid by the employer, whether an individual or corporation, is fully deductible from gross income for federal income tax purposes.

130. E.g., Cal. Rev. & Tax. Code § 17146 states that retirement pay not based on disability is to be included in gross income, except that it is subject to the military pay exclusion of $1000 per year.


132. The federal unemployment tax rate is 3.1% of the first $3,600 of wages paid during the calendar year to each employee. Since this tax is imposed on employers, it should not be deducted from the wages of employees. The employer is allowed a credit against the federal tax for required contributions of state unemployment funds up to 50% of the federal tax. Therefore, most employers pay a little more than three-tenths of 1% in federal unemployment tax.

133. As of January 1, 1963, the social security tax rates are 3 5/8% for employers and 3 5/8% for employees, or a total of 7 1/4%. (The rates for wages paid in 1962 were only 3 1/8% from both employer and employee.) These rates are applicable to the first $4,800 of wages paid on or after January 1, 1963, whether the wages were earned prior to or after that date. Int. Rev. Code of 1954, §§ 3101(2), 3111(2). Thus, the employer will withhold $174 from the employee's salary or wages.

134. Int. Rev. Code of 1954, § 162. These contributions are not deductible under § 164(b)(3). That section specifically excludes federal excise taxes from the general provision for deductibility of taxes paid or accrued within the taxable year. Sections 3111 and 3301 specifically provide that such contributions are excise taxes. The deduction of social security taxes by the employer is, therefore, allowed under § 162 as an ordinary and necessary business expense.
However, the employee, in computing his individual federal income tax, may not deduct the amount which his employer has withheld from his wages.

These tax collections are held in trust funds, from which the aforementioned benefits are paid. Social security benefit payments have always been presumed to be exempt from federal income taxation, although no specific statutory exemption has ever been enacted. The Internal Revenue Code of 1954, its predecessors and social security legislation are silent in this regard. It would appear that under the broad definition of gross income, which includes "all income from whatever source derived," both these benefits and that portion of the employer's contribution which is paid to the employee would be subject to federal taxation. But this has not been the case.

Even in the absence of any specific exemption these payments have not been held to be gross income by the Internal Revenue Service. As early as 1941, an office ruling issued by the Income Tax Unit of the Bureau of Internal Revenue stated that social security benefits "are not subject to Federal income tax in the hands of recipients." On November 20, 1957, the Internal Revenue Service, through the adoption of the final regulations to Section 61 of the Internal Revenue Code, publicly stated its position on this point: "Amounts received as pensions or annuities under the Social Security Act . . . are excluded from gross income."

The federal government's treatment of these benefits, however, has not been uniformly followed by the states. For state tax purposes old age survivors insurance and unemployment compensation payments have been treated differently. While all the states, with one notable exception, have followed the federal law in holding old age survivors insurance payments tax exempt, their basis for making this determination has varied considerably. For example, Delaware, Minnesota and Virginia have made such payments exempt by statute. Alabama, Utah and Wisconsin have held the payments tax exempt by informal ruling.

137. Treas. Reg. § 1.61-11(b) (1957).
138. Ibid.
139. In Mississippi, the individual employee is taxed on any amount which he receives in excess of his contribution, i.e., any amount that has already been deducted by the employer. Letter From Chief of Income Tax Div., March 27, 1939, in 1 CCH State Tax Cas. Rep. Miss. ¶ 10-617.85.
New York has adopted federal adjusted gross income, and thereby exempted such payments. Hawaii, Idaho, Iowa and North Dakota have simply followed the federal law, and in Massachusetts the court reversed an informal ruling of the State Tax Commissioner which held such payments subject to taxation.\textsuperscript{141}

\textit{Commissioner v. Gray}\textsuperscript{142} is the most recent case on this point. There, the taxpayer reported income from wages only and paid the tax thereon. The Commissioner imposed an additional tax of twenty-five per cent on $920 in old age survivors insurance payments contending that such payments were in fact "retirement allowances" and, hence, taxable under a Massachusetts statute.\textsuperscript{143} The court, in holding that the payments were not to be included in gross income, reasoned as follows:

Old age benefits do not readily fit within the general concept of business income in the nature of wages. They certainly are not in terms within the most nearly applicable provision of \$ 5(b), relating to "retirement allowances ... from the commonwealth or any county, city, town, or district thereof, or from any person." Such benefits, financed by a nationally administered tax program, were unknown in 1920 when this provision was first enacted. They are received from the Federal government, not from a former employer. They rest not upon any contract of employment but upon statutory provisions.\textsuperscript{144}

While conceding that in a general sense these payments arise from the employer-employee relationship, the court nevertheless concluded that they could not be said to be wholly in the nature of further compensation for services rendered and taxable accordingly. Thus, the court lined up Massachusetts with the vast majority of states and the federal government in holding old age survivors insurance payments tax exempt.

Among the states which tax income, only Colorado, North Carolina, Oklahoma, Utah and Wisconsin imposed a tax on unemployment compensation payments. Mississippi, alone, taxes both unemployment compensation and old age survivors insurance payments but limits such taxation to payments received in excess of the employee's contribution.\textsuperscript{145}

VI. \textsc{Railroad Retirement Benefits}

While there exists a lack of uniformity in taxing most retirement benefit payments, all the states, albeit reluctantly in some instances, have

\textsuperscript{142} Ibid.
\textsuperscript{143} Mass. Gen. Laws ch. 62, \$ 5(b) (1958).
\textsuperscript{144} 340 Mass. at 540, 165 N.E.2d at 407-08.
\textsuperscript{145} See note 139 supra and accompanying text. Unemployment compensation payments made to (laid-off) employees should be distinguished from voluntary company financed supplemental unemployment benefit plans such as guaranteed annual wage plans which are generally taxable.
exempted benefits paid under the Railroad Retirement Acts.\textsuperscript{146} This unanimity has resulted neither by chance nor by choice, but was dictated by Congress. The acts specifically provide that payments shall not be "subject to any tax."\textsuperscript{147} Although the states have yielded to this congressional mandate, they have reached the decision to exempt these payments from income taxation by pursuing various avenues of approach.

New York has adopted federal adjusted gross income as the basis of state taxation and since payments under the Railroad Retirement Acts are specifically exempted from any tax, they are subject to no New York state income tax.

"Amounts paid by carriers as pensions to retired employees in addition to annuities or pensions paid by the Railroad Board, however, are included in gross income."\textsuperscript{148} Maryland has similarly ruled on payments under the Railroad Retirement Act and the Railroad Unemployment Insurance Act and further held that contributions to the Railroad Retirement Fund are not deductible.\textsuperscript{149}

The history of exemption in Wisconsin is interesting. A state statute exempted pensions received from the United States Government.\textsuperscript{150} The Wisconsin Department of Taxation, however, attempted to tax railroad retirement payments on the ground that they were received not from the United States, but from the railroad, with the federal government merely acting as the middle man through whom the pension was paid. In \textit{Doner v. Wisconsin Dept' of Taxation},\textsuperscript{151} the pension in question was held not to be subject to the Wisconsin income tax. Payments from the Railroad Retirement Board were adjudged to constitute a pension within the meaning of the Wisconsin statute, in that they were derived from the general funds of the United States Treasury rather than from a separate fund consisting of taxes paid by employer and employee. It was not until fifteen years later that the Wisconsin Department of Taxation by letter\textsuperscript{152} formally recognized this decision by exempting Railroad Retirement payments from state income taxation.


\textsuperscript{150} Wis. Stat. Ann. § 71.03(2) (a) (1957).

\textsuperscript{151} 1 CCH State Tax Cas. Rep. Wis. ¶ 10-708.60 (Cir. Ct., Langlade County, 1942).

\textsuperscript{152} Letter From Tax Counsel, Wisconsin Dept' of Taxation, March 1, 1957, in 1 CCH State Tax Cas. Rep. Wis. ¶ 10-708.70.
Other states which have failed to enact specific legislation, issue rulings, or litigate the matter, have simply stated that such payments are exempt in the instructions given taxpayers for filing state income tax returns.  

VII. CIVIL SERVICE ANNUITIES

Payments received under the Federal Civil Service Retirement Act are generally subject to state income taxation, 154 although the methods of taxing such payments vary among the states in the same manner in which taxation of commercial and industrial annuities differ. By way of illustration, in Virginia the recipient is entitled to receive the total amount of his contribution paid into the system tax free, before he is regarded as having received taxable income. 155 Once the benefits received equal his total contribution, additional payments are regarded as gross income for state tax purposes.

On the other hand, Maryland, while treating all payments received pursuant to the Federal Civil Service Retirement Act as pension and annuity income, applies the "three per cent" rule. 156 Under this rule as noted previously, if payments are received in annual installments, only the amounts received in any taxable year which equal three per cent of the aggregate premiums paid by the annuitant, even if paid during that taxable year, are considered gross income. As soon as the total amounts received and excluded from gross income equal the aggregate premiums paid, any payments received thereafter are taxable as gross income. 157

Those states, e.g., Kansas, 158 which follow the "federal rule," tax civil service retirement payments but exclude a certain portion of each payment from gross income. The portion excluded is determined by means of a formula termed the "exclusion ratio" which equals the ratio which the investment in the contract bears to the expected return under the contract as of the annuity starting date. Generally, the portion of the payment excluded will be the amount contributed by the employee to the civil service program, divided by his life expectancy at the time payments

153. Instructions For Preparing Form 760, Commonwealth of Virginia Dep't of Taxation, p. 5; Kansas Income Tax Instructions For Form 40, p. 2. However, it should be noted that the exemption of railroad retirement benefits from inheritance taxation in Virginia is specifically provided for by statute. Va. Code Ann. § 58-153 (Supp. 1962).

154. Instructions For Filing Form 540, State of California, p. 4; Instructions For Preparing Form 760, Commonwealth of Virginia Dep't of Taxation, p. 6. See also note 125 supra.


156. See note 125 supra.

157. See note 99 supra and accompanying text for a discussion of this rule.

158. Kansas Income Tax Instructions For Form 40, p. 2.
began. This exclusion ratio will remain constant regardless of how long
the annuitant lives and even though monthly payments increase in
amount.159

Thus federal employees who receive payments pursuant to the Civil
Service Retirement Act, generally must include such payments in gross
income for state tax purposes, while payments under the Social Security
Act and Railroad Retirement Act are received tax free with few excep-
tions. It would appear, therefore, that the federal employee is burdened
by a form of tax discrimination. Not only does this seem to be
unjustified, but completely contrary to the federal government's avowed
policy of attracting capable people by affording fringe benefits in the
form of tax sheltered payments.

The question of whether Congress has the power to exempt such pay-
ments from state taxation, has been raised, but remains unanswered.
Concurring in Graves v. New York ex rel. O'Keefe,160 Mr. Justice Frank-
furter stated:

Whether Congress may, by express legislation, relieve its functionaries from their
civic obligations to pay for the benefits of the State governments under which they
live is a matter for another day.161

That day has not yet arrived, and until it does the taxpayer receiving
civil service retirement payments must report them as taxable income
on his state tax return.

VIII. WORKMEN'S COMPENSATION PAYMENTS AND PERSONAL INJURY
DAMAGE AWARDS

While workmen's compensation payments generally provide the tem-
porarily disabled or injured employee with a source of continuing income
during the period of incapacity, these payments are often equivalent to
retirement income in cases where the employee is completely disabled
or forced to retire. The states have uniformly exempted such payments
from gross income. Typical of the statutes enacted is that of California162
which provides as follows: "[G]ross income does not include—(1)
Amounts received under workmen's compensation acts as compensation
for personal injuries or sickness..." The regulations applicable to this
section of the California statute further provide that such payments are

160. 306 U.S. 466 (1939).
161. Id. at 492 (concurring opinion).
(Supp. 1962); Wis. Stat. Ann. § 71.03(2) (1957) and Wis. Admin. Code, Tax § 3.61, 1
CCH State Tax Cas. Rep. Wis. ¶ 10-709(1).
excluded from gross income if made pursuant to a "statute in the nature of a workmen's compensation act,"\textsuperscript{163} and for personal injuries or sickness incurred in the course of employment. Furthermore, such payments are nontaxable when paid "to the survivor or survivors of the deceased employee."\textsuperscript{164}

The states, for the most part, have appended to the workmen's compensation tax exclusion legislation additional provisions for the exclusion of damage awards for personal injuries. For example, the California statute expressly provides that gross income does not include "the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. . . ."\textsuperscript{165} The California Tax Regulations define "damages received" as an amount received (other than workmen's compensation) through the prosecution of an action sounding in tort or through a settlement agreement entered into in lieu of such prosecution.\textsuperscript{166}

As in the case of workmen's compensation payments, damages recovered for injuries are not considered retirement benefits per se. But they may amount to such in the situation where the injuries force the individual into retirement.

IX. INSURANCE PROCEEDS

Life insurance proceeds paid in a lump sum by reason of the death of the insured are not generally looked upon as a source for funding the retirement years of the beneficiary. However, they often serve this purpose, particularly in the case of the surviving spouse. In sheltering such payments from taxation, the states have frequently followed the rules set forth by the federal government in Section 101 of the Internal Revenue Code. In brief, the proceeds of life insurance paid, by reason of the death of the insured, to his estate or beneficiary, directly or in trust, are excluded from the gross income of the recipient.\textsuperscript{167}

Speaking conventionally, in terms of retirement income, life insurance proceeds may be called upon to fund retirement years where the insured, or in the case of his death, the beneficiary, elects under the terms of the policy to have the insurer retain the total sum due and merely distribute the interest thereon periodically or allocate installments of principal and interest to the insured or the beneficiary. The interest paid on the funds does not enjoy the same tax exempt status as do the proceeds paid by

\begin{itemize}
\item \textsuperscript{163} Cal. Tax regs., § 17138(a) (1), 1 CCH State Tax Cas. Rep. Cal. ¶ 15-735(b).
\item \textsuperscript{164} Ibid.
\item \textsuperscript{165} Cal. Rev. & Tax. Code § 17138(a) (2).
\item \textsuperscript{166} Cal. Tax regs., § 17138, 1 CCH State Tax Cas. Rep. Cal. ¶ 15-735(c).
\item \textsuperscript{167} Cal. Rev. & Tax. Code §§ 17131-33.
\end{itemize}
reason of the insured's death, but is generally reportable as gross income. 168

Amounts received under a life insurance or endowment policy (other than amounts paid by reason of the death of the insured, interest payments on such amounts, and amounts received as annuities) are not taxable. . . . [Until their aggregate] . . . exceeds the aggregate premiums or consideration paid whether or not paid during the taxable year. 169

Accordingly, the investment can be recouped tax free—only the increment is taxable. Similarly excluded from gross income is the "amount received by the insured as a return of the premiums paid by him under life insurance or endowment contracts, either during the term or at maturity" 170 or at the surrender of the contract.

X. CONCLUSION

As the types of retirement plans, as well as the number of persons participating in them, continue to increase, the question of state tax liability for payments received therefrom becomes increasingly more important. Unfortunately, this area of the law is far from clear not only because all forms of retirement payments are not covered by the state tax codes, but also because many states have been forced to handle the problems involved on an informal case by case basis, without the aid of complete or comprehensive regulations, rulings or case law. In many instances, definitive rules of law are completely lacking as to certain types of payments. Moreover, even where applicable statutes, administrative regulations or informal interpretations are available, the states have embarked on divergent methods of tax imposition. General trends and methods are nevertheless perceptible. Accordingly, the often repeated caveat is most applicable to state taxation of retirement benefit payments: Care must be taken to insure the proper reporting of such payments.

